BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SCHOLL, INC., ET AL.)

Appearances:

For Appellant: Valentine Brookes
Attorney at Law

For Respondent: Brian W. Toman
Counsel

O P I N I O N '

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Scholl, Inc. (formerly The Scholl Manufacturing Co., Inc.), Dr. Scholl's Foot Comfort Shops, Inc., Arno Adhesive Tapes, Inc., and Podiatry Supply Headquarters, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Appeal of Scholl, Inc., et al.

Appellant	Income Year	Proposed Assessment
Scholl, Inc.	1967	$ 9,834.00
	1968	9,143.00
	1969	8,861.00
	1970	12,119.00
Scholl Manufacturing Co., Inc.	1962	$ 67.13
	1966	131.95
Dr. Scholl's Foot Comfort Shops, Inc.	1962	$ 3,764.37
	1963	3,899.31
	1964	4,412.49
	1965	4,683.27
	1966	5,805.18
Arno Adhesive Tapes, Inc.	1962	$ 715.27
	1963	485.82
	1964	401.88
	1965	349.65
	1966	302.56
Podiatry Supply Headquarters, Inc.	1962	$ 298.95
	1963	246.76
	1964	392.90
	1965	376.55
	1966	473.31

The central issue for resolution is whether the operations of Scholl, Inc. (formerly The Scholl Manufacturing Co., Inc.) and its domestic and foreign subsidiaries constituted a unitary business.

When a taxpayer derives income from sources both within and without California, it is required to measure its California franchise tax liability by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with affiliated corporations, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 161 (1947); John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569] (1951), app. dism. 343 U.S. 939 [96 L. Ed. 1345] (1952).)

The California Supreme Court has determined that a unitary business is definitely established by the

existence of: (1) unity of ownership: (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, 17 Cal. 2d 664, 678 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L. Ed. 991] (1942).) The court has also held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. (Edison California Stores v. McColgan, supra 30 Cal. 2d at 481.) These principles have been reaffirmed in more recent cases. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 401 (1963).)

The existence of a unitary business may be established if either the three unities or the contribution or dependency test is satisfied. (Appeal. of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) Implicit in either test, of course, is the requirement of quantitative substantiality., (Appeal of Beatrice Foods Co., Cal. St. Bd. of Equal., Nov. 19, 1958; Appeal of Public Finance Co., Cal. St. Bd. of Equal., Dec. 29, 1958; see also Superior Oil Co. v. Franchise Tax Board, supra.) In other words, corporations are engaged in a unitary business within the scope of either test if, because of the unitary features, the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporations.

To facilitate discussion, the domestic and foreign operations will be discussed separately.

1. Domestic Operations

Scholl, Inc. (hereinafter sometimes referred to as appellant or parent) was originally incorporated in New York in 1913 as The Scholl Manufacturing Company, Inc. It is-the parent or successor to several related companies including all the other appellants, [1/] the first of which was founded by the late Dr. William M.

1/ Appellants have conceded all aspects of domestic unity except between Scholl, Inc., and Arno Adhesive Tapes, Inc.

Scholl in 1904. Scholl, Inc., began business in California in 1941. It owns all the stock of the domestic subsidiaries. The controlling stock interest in Scholl, Inc., was owned by Dr. Scholl until his death in 1968. The parent and its affiliates are engaged in the manufacture and distribution of Dr. Scholl's foot and leg care products, as well as Scholl shoes and footwear. Since the introduction in 1904 of an arch support developed by Dr. Scholl, appellant has introduced more than 500 foot and leg care products. Dr. Scholl's foot and leg care products include various foot pads, cushions, supports, toiletries and proprietary products for use on corns, callouses, bunions and other common foot and leg discomforts, exercise sandals and elastic support hosiery. The category of foot and leg care products also includes some podiatry services. Foot and leg care products are distributed through a variety of independent retail outlets, such as drug stores, shoe stores and department stores, as well as through Scholl owned or licensed Foot. Comfort Shops. Scholl also markets various styles Of shoes for men, women and children, approximately 50 percent of which are sold through the Foot Comfort Shops while the balance are marketed by department stores and independent retail shoe outlets.

Arno Adhesive Tapes, Inc. (Arno) manufactures and sells pressure sensitive adhesive tape products under the Arno name. Although originally established by Dr. Scholl in 1929 to produce the adhesive coated materials needed to manufacture Zino pads, Arno has become a major supplier of tapes, adhesives and similar products for home and industrial use. 'During the years.1965 through 1970, 18.87 percent of Arno's total sales'were to its parent. In actual dollar amounts this reflects sales from a low of $1.68 million in 1965 to a high of $2.58 million in 1970. 2/ The tape products sold to parent are an essential component of the various pads, plasters and certain other products manufactured and distributed by parent.

During the years in question both Dr. Scholl and Mr. H. A. Coldiron were directors and officers of both Scholl, Inc., and Arno. Dr. Scholl was the president of Scholl, Inc., and chairman of the board for Arno

2/ Sales to the parent exceeded $1.55 million in 1962, 1963 and 1964 althoush insufficient data was submitted to determine the percentage of Arno's total sales represented by those intercompany transactions.

while Mr. Coldiron was an executive vice president and general manager of Scholl, Inc., and president of Arno. Mr. Coldiron was also general manager of all the domestic operations.

Appellants have engaged in concerted nationwide advertising campaigns during the appeal years. These nationwide campaigns utilized radio, television, magazines and newspapers. The Dr. Scholl Zino pad has been a central product in the advertising campaigns. Arno is the sole supplier of the adhesive coated materials for the Zino pad. Appellants utilize the same certified public accounting firm and have a common insurance carrier.

We believe that under an application of either the "three unitites" test or the "contribution or dependency" test Arno is unitary with Scholl, Inc., and the other domestic subsidiaries.

A. Three Unities Test

Unity of ownership is clearly present since Scholl, Inc., owned all the stock of Arno as well as the other domestic subsidiaries.

Unity of use, which is concerned with line functions, relates to executive forces and operational systems. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App. 3d 496 [87 Cal. Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L. Ed. 2d 3811 (1970).) One of the most striking factors illustrating unity of use is the substantial intercompany sales between Arno and its parent. Although appellantwould have us believe that the sales were inconsequential, we conclude otherwise. Initially, Arno was created to provide its parent with adhesive materials which were essential to the production of its finished goods for ultimate distribution. During the years in issue, approximately 20 percent of Arno's sales were to the parent, thus guarantying Scholl, Inc., a source of supply and assuring Arno a substantial market for its products. Such a guaranteed outlet permitted Arno to purchase materials in greater quantities and undoubtedly resulted in economies of scale which were beneficial to both corporations. (See, e.g., Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of Harbison-Walker Refactories Co., Cal. St. Bd. of Equal., Feb. 15, 1972.)

The existence of an integrated executive force is also a most important indicator of unity of use. (See,

e.g., Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of F. W. Woolworth Co., supra.) Here, such integration is established by the key executive positions held by Dr. Scholl and Mr. Coldiron. The mutual benefits accruing to each corporation by having the chief executive officer of the other serve on its board of directors is apparent. The mutual benefits are particularly evident here, since Mr. Coldiron was the general manager of all the domestic subsidiaries. The ability of the companies to profit from a pooling of the technical knowledge, experience and expertise possessed by these seasoned executives would seem to be of immeasurable value.

Unity of operation concerns those activities which may be classified as staff functions. (Chase Brass & Copper Co. v. Franchise Tax Board, supra.) In the instant appeal, the primary indicator of operational unity is the concerted nationwide advertising program. Appellant argues that since the nationwide advertising program relates to foot pads and foot powders and not to any of Arno's products, it is not evidence of unity in any respect. We do not believe appellant's objection is well taken. The Dr. Scholl Zino pad was a central product in the advertising campaign. Since Arno was the sole supplier of the adhesive materials for the Zino pad, advertising which increased the sales of Zino pads directly benefited Arno. There was no reason to advertise adhesive materials for Zino pads when advertising the Scholl Zino pad alone would benefit both Arno and its parent. Undoubtedly, both Arno and its parent advertised other products which they produced separately. However, this does not change the fact that the program of concerted advertising was mutually beneficial and, therefore, evidence of operational unity.

Additional, although certainly not conclusive, evidence of the existence of unity of operation is the use of the same firm of certified public accountants and a common insurance carrier.

B. Contribution or Dependency Test

The substantial mutual contributions and benefits flowing from an integrated executive force between affiliated corporations have been given increasing weight by the courts as well as this board. (See, e.g., Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of F. W. Woolworth Co., supra; Appeal of Browning Manufacturing Co., Cal. St. Bd. of Equal., Sept. 14, 1972.)

As noted above such integration exists here. The existence of the centralized service functions discussed above is also an indicator of contribution and dependence. (See, e.g., Superior Oil Co. v. Franchise Tax Board, supra; Honolulu Oil Corp. v. Franchise Tax Board, supra.) Substantial interdivisional or intercorporate product flow consistently has been regarded as one of the most basic unitary connections establishing contribution and dependency. (See, e.g., Appeal of Beecham, Inc., Cal. St. Bd. of Equal., March 2, 1977; Appeal of Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975.) Mutual dependence and contribution are established in this appeal by the parent's guaranteed demand for a substantial amount of Arno's production, while Arno provided an assured source of supply for its parent's essential material requirements.

In opposition to respondent's determination of domestic unity appellant advances three arguments. First, appellants argue that Arno should not be included in the domestic unitary group because it sold products different from the parent. We do not agree. Arno was established initially to provide Scholl, Inc.,. with adhesive materials essential to the production of many of its foot and leg care products. Duringthe years in issue Arno continued to function as the sole supplier of these products. That Arno also sold tape and other adhesive products to organizations outside the Scholl grou, does not derogate from the mutual dependency and contribution discussed above, which establishes Arno as part of the Scholl domestic unitary group. (See North American Cement Corp. V. Graves, 269 N.Y. 507 [199 N.E. 5101 affd. per curiam 299 U.S. 517 [81 L. Ed. 381] (1936) cited with approval in Butler Bros. v. McColgan, supra, 17 Cal. 2d at 673.)

Next, appellants argue that the fact that Arno markets products under the Arno name rather than the Scholl name is evidence of lack of unity. The use of a common trade name has been recognized as one element evidencing the unitary nature of a business. (See, e.g., Appeal of F. W. Woolworth Co., supra; Appeal of Perk Foods Co. of California, Cal. St. Bd. of Equal., Nov. 23, 1966.) However, such factor, standing alone, has never been sufficient to establish unity. (Cf. Appeal of H & R Block, Inc., Cal. St. Bd. of Equal., June 6, 1968.) Similarly, the lack of a common name 3/ is

3/ It is interesting to note that when established by Dr. Scholl, Arno was named after a faithful German shepherd dog owned by the doctor in his youth.

insufficient to preclude a finding of unity in the face of the substantial unitary characteristics discussed above.

Rather than attacking respondent's determination of domestic unity directly, appellant's final argument asserts that the formula produces unacceptable distortion.. It is appellant's position that the profit margin of Scholl, Inc., was so different from Arno's that the distortion resulting from a combined report would prevent a reasonably accurate determination of net income. 4/ According to appellant, the cornerstone of its argument is that the apportionment formula implicitly assumes that all sales produce the same gross profit. Appellant contends that use of the formula's sales factor, which employs gross sales as the apportioning measure, produces distortion when two or more enterprises have different gross profit margins. Since the differing gross profit margins reflect different manufacturing profit, appellant continues, application of the property and payroll factors adds to the distortion by allocating to sales territory income properly attributable to the manufacturing function.

We believe the decision in John Deere Plow Co. v. Franchise Tax Board, supra, requires that appellant's argument be rejected. (cf. Chase Brass & Copper Co. v. Franchise Tax Board, 70 Cal, App. 3d 457, 472 [138 Cal. Rptr. 9011 (1977), app. dism. -- U.S. -- [54 L. Ed. 2d 7771 (1978).) In Deere the taxpayer argued that, in relation to its California business, the formula disregarded the differences in both the operating expenses

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4/ Appellant's argument involves a comparison of the profit margins between Scholl, Inc., and Arno. Since appellant has conceded the unitary relationship between Scholl, Inc., and all other members of the Scholl domestic group, a more appropriate comparison of profit margins would be between Arno and the rest of the combined Scholl domestic group. Representative profit margin figures for 1965 and 1969 are:

	Gross Profit Margins		Net Profit Margins	
	1965	1969	1965	1969
Arno	34%	43%	4.9%	8.0%
Scholl, Inc.	56.2%	60%	8.2%	10.2%
Scholl domestic group	52%	**51.4%**	**6.0%**	**8.0%**

and the productivity of income from the three factors of property, payroll and sales. In rejecting this argument the court stated in 38 Cal. 2d at 223-225:

> But in so.arguing plaintiff fails to take into account the underlying concept of formula apportionment in the allocation of income from a unitary business: that the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of the formula method in assigning to the taxing state its fair share of taxable values. ... The fact that the taxpayer may show that according to a separate accounting system, the activities in the taxing state were less profitable than those without the state, or even resulted in a loss, does not preclude use of a formula as a method of apportionment of the unitary income. ... The only requirement is that the formula used be not intrinsically arbitrary or produce an unreasonable result. ...
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> In the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income. .. but its propriety in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process.

Factually, Deere concerned a situation where the net profit margin of the California enterprise varied from the net profit margins of the rest of the Deere

operations. However, the thrust of the case is equally dispositive of appellant's argument that the variance of the gross profit margins caused impermissible distortion. Accordingly, we cannot conclude that the formula was intrinsically arbitrary or produced an unreasonable result.

2. International Operations

Scholl, Inc., has many foreign subsidiaries in a number of foreign countries located in both the eastern and western hemispheres. 5/ The principal subsidiaries are located in England, Germany and Canada. The foreign subsidiaries also distribute foot and leg care products as do the domestic corporations. During the appeal years, however, there were many significant differences as well as similarities in products, management and operations which we will discuss.

The first foreign subsidiary was established in London in 1910 by Frank J. Scholl, Sr., Dr. Scholl's brother. Originally, the principal business of the British subsidiary was the giving of foot manipulation and the fitting and sale of arch supports by chiropodists trained locally. The British subsidiary expanded until during the appeal years it manufactured a broad line Of foot and leg care products which were sold through company owned and licensed shops and through drug stores and other independent retail outlets. The British subsidiary also manufactured products for sale to other

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5/ The foreign subsidiaries and the extent of Scholl, Inc.'s stock ownership interest are as follows:

Western Hemisphere

Argentina - 100%
Brazil - 100%
Canada - 63%
Costa Rica - more than 50%
Mexico - 100%
Venezuela - more than 50%

Eastern Hemisphere

Australia - more than 50%
Austria - more than 50%
Belgium - 71%
Denmark - more than 50%
England - 71%
France - 71%
Germany - 71%
New Zealand - 71%
Norway - more than 50%
South Africa - 71%
Sweden - more than 50%
Switzerland - more than 50%

eastern hemisphere subsidiaries., The Canadian subsidiary which was also established in 1910, the German subsidiary, and other foreign subsidiaries operated in a similar manner.

During the development of Scholl's domestic operations the manufacture and distribution of shoes became a significant part of the domestic operation. 6/ However, when the domestic companies, began to sell shoes the foreign operations did not.. The decision not to sell shoes reflected a basic policy disagreement between Dr. Scholl and his brother Frank; the latter believing that shoes were not, a true foot comfort item. Consequently, he did not want to make shoe stores out of foot comfort shops. In accordance with this policy, during the years in issue the foreign corporations sold no shoes manufactured by Scholl in the United States. In the isolated instances where shoes were sold, they were acquired from manufacturers outside the Scholl group and were designed in accordance with the requirements and specifications of local management.

Other products sold by the foreign affiliates were also manufactured in the foreign countries in which they operated and were not manufactured in the United States by any member of the Scholl group. These products were designed, manufactured, packaged and distributed locally in accordance with local needs and pursuant to the direction of local management.

One of the most impressive features of this appeal is the absence of any significant sales from the domestic Scholl group to the foreign subsidiaries during the years in issue. Although the record does not contain complete financial information for all the years on appeal, we have been able to develop some comparative data. For the years 1962 through 1964 and 1967 through 1970 the average sales from the domestic group to the foreign subsidiaries were $154,000 per year. A comparison of this average to the sales of the domestic group for the years 1965, 1969 and 1970, the only years these figures are available, indicates that sales from the

6/ For example, shoe sales accounted for slightly less than 30 percent of the total sales of the domestic group during the years 1967-1970. Actual net shoe sales varied from approximately $12 million in 1967 to $16 million in 1970.

domestic group to the foreign subsidiaries expressed as a percentage of the domestic group's total net sales were .4 percent in 1965, .3 percent in 1969 and .3 percent in 1970. The record also indicates that there may have been some sales from the foreign subsidiaries to the domestic group during a few of the years on appeal. Unfortunately, these figures also include sales among the foreign subsidiaries in an unascertainable amount. Accordingly, we can draw no valid conclusion regarding these transactions.

Until his death in 1968, Dr. Scholl was a director and officer of Scholl, Inc., and the British, German, Mexican and Canadian subsidiaries. For all the appeal years Charles F. Scholl, the son of Frank J. Scholl, Sr., and nephew of Dr. Scholl, was a director and officer of the parent and the Canadian subsidiary. For all the years from 1967 he was a director and officer of the British subsidiary. From 1962 through 1967 Frank J. Scholl, Sr. was a director and officer of the parent and the Australian, German and Mexican subsidiaries. From 1962 through 1966 he was also a director and officer of the British, South African and Belgian subsidiaries. Prior to 1968 there were neither common directors nor common officers serving with the subsidiaries in the following countries: Argentina, Brazil, Costa Rica, Venezuela, Austria, Denmark, France, New Zealand, Norway and Switzerland. In 1968 William H. Scholl, the son of Frank J. Scholl, Sr. and nephew of Dr. Scholl, became a director of Scholl, Inc., and of all of the foreign subsidiaries.

Ostensibly, interlocking directorates were present, at least between the parent and some of the foreign subsidiaries. However, the importance normally attached to interlocking directorates and integrated executive forces in a unitary business setting is substantially diluted when the nature of actual management, even at the highest levels, is examined. The testimony of T. P. Bart, the parent's controller and director of finance for 24 years including all the appeal years, is particularly illuminating.

Mr. Bart's testimony is summarized as follows: The Scholl subsidiaries in the eastern hemisphere were directed from London by Frank J. Scholl, Sr., who was the chief executive solely responsible for making all managerial decisions and implementing them through his subordinates. Dr. Scholl was confident that his brother had a greater grasp of the eastern hemisphere business operations and did not interfere in the management of

the business in that geographic area.. No formal reports were made to Dr. Scholl or others at the Scholl domestic headquarters in Chicago. Not even annual financial statements reflecting net earnings were.submitted to the parent. During the years in issue, the only concern Of the parent's management with the foreign subsidiaries was whether they were in a position to declare dividends.

During the appeal years the names of the foreign subsidiaries' officers and directors were not known to the Chicago office. Although Scholl, Inc.,owned a majority of the stock of the foreign subsidiaries, its voting rights were exercised pursuant to proxies given to Frank J. Scholl, Sr., with respect to the eastern hemisphere subsidiaries. Notwithstanding the exercise of some supervisory control over the western hemisphere subsidiaries, the nature and extent of which does not appear in the record, the officers and directors of these subsidiaries were also designated by the resident manager of the foreign subsidiary pursuant to proxies received from the Chicago office.

Shortly after joining Scholl, Inc., in the early 1950's, Mr. Bart, with the assent of Dr. Scholl, attempted to schedule a trip to Europe to familiarize himself with European operations. However, Frank Scholl would not agree to the visit on the grounds that he did not want anyone from Chicago looking over his shoulder. Five years later, in 1957, Mr. Bart was finally permitted to make a European trip although he was not allowed to inspect the books and records of any of the eastern hemisnhere subsidiaries. Occasional trips were made to Europe by Mr. Bart during the early 1960's, but it was not until plans for the public offering 7/ were implemented that he obtained access to any financial or operating information.

7/ Sometime after William Scholl became the chief executive officer of Scholl, Inc., apparently during 1969, the decision was made to register Scholl, Inc.'s stock with the Securities and Exchange Commission. As a result of the decision to "go public", substantial information was required from the foreign subsidiaries in order to file the registration statements required by the Commission. Ultimately, the statements were filed and registration was completed in 1971 when stock was offered to the public.

Mr. H. A. Coldiron, who was Scholl, Inc.'s executive vice president and general manager of the domestic operations from 1952 through 1968 never made a trip to any of the eastern hemisphere subsidiaries. Similarly, D. W. Landon, a vice president and treasurer of Scholl, Inc., until the late 1960's never visited the eastern hemisphere operations. Prior to the retirement in 1967 of Frank J. Scholl, Sr. from the business for health reasons, no officer or director of the eastern hemisphere corporation ever visited Chicago. Dr..Scholl, however, did visit London once or twice a year during the appeal years, and Frank Scholl visited the United States approximately three times a year during the same period. During the course of these visits, some general business discussions occurred.

Respondent has attempted to establish the international transfer of employees. However, during the appeal years there were no such transfers. In the entire Scholl existence respondent could point to only one transfer, involving a bilingual machinist who went to Europe for temporary periods on two occasions. A second purported transfer involved an employee who immigrated to the United States from London and ultimately became the manager of a Scholl Foot Comfort Shop. The only other transfer involved, not a permanent Scholl employee, but a temporary office worker for Western Girl previously employed by Scholl who went to Mexico City to assist in opening a new Western Girl office in that locality.

The operations of the eastern hemisphere corporations directed from London by Frank J. Scholl, Sr., produced their own executives and did not draw on the United States parent or any of the domestic affiliates as a training ground. The executives were trained locally in their companies and not in the United States. Accounting was done locally by locally trained personnel operating under accounting standards required to satisfy local accounting and tax requirements.

During World War II, the Scholl operation in Germany was totally destroyed and the London facilities were badly damaged. Shortly after the war/Scholl, Inc., was requested to provide the necessary funds to rebuild. The request was refused, however, without any funds being advanced to assist in reconstruction. The necessary funds were obtained primarily from the London company and to a lesser extent from the German operation. As a result of this refusal, the directors of the eastern

hemisphere subsidiaries have been most reluctant to declare dividends which would accrue to the United States parent. Although some dividends were declared, they were sparse and erratic. In one case the dividend was in the form of an interest bearing note payable over a five-year period.

Trademarks and some patents were available to all members of the foreign group. In its registration statement filed with the Securities and Exchange Commission, Scholl, Inc., stated that it had numerous patents, the most important of which dealt with the exercise sandal. It also stated, however, that none of the patents were material to its operation. In the same document Scholl, Inc., also stated that it had numerous trademarks registered in the United States and foreign countries, several of which, including Dr. Scholl's, Scholl's, Zino pads and Foot Comfort, were considered material to operations. At no time, however, did the foreign and domestic corporations engage in any international institutional advertising, or in any other integrated marketing endeavor. The foreign corporations designed their own packaging and displays, and were responsible for the creation of their own advertising. Since each foreign corporation was required to appeal to a particular domestic market, its marketing efforts were individually tailored to meet the demands of that specific area. Notwithstanding the individualization of foreign marketing efforts, Scholl products usually were distributed in the familiar yellow package.

The exercise sandal mentioned above was developed and patented in the United States and then registered abroad. Originally, the sandals for domestic distribution were made in the United States from Austrian ash, a wood from trees grown only in Austria. The wood was imported from a nonrelated Austrian company. The foreign subsidiaries made their own exercise sandals from the same wood for sales in their marketing areas. In Europe, where wooden shoes had been accepted for centuries, the exercise sandal was a high style item and was sold for its appearance. In the United States, however, where it was sold for its therapeutic value, it was marketed in spite of its appearance. Prior to 1968 virtually all sales of exercise sandals were made in foreign countries. During 1968, 1969 and 1970, sales in the United States accounted for approximately 3 percent, 12 percent and 11 percent, respectively, of total exercise sandal sales. This amounted to approximately $1.9 million in 1969 and $2.1 million in 1970 or approximately 4 percent of total

domestic sales in each of those years. In 1971, after the years in issue, a new foreign subsidiary was established to manufacture the exercise sandal in Austria where the wood was derived. The manufactured sandal was then sold to the European companies and to the parent corporation by the new Austrian subsidiary.

The year 1968 marked the commencement of a transitional period for Scholl, Inc., which was to continue until 1971. It was in 1968 when, for the first time in Scholl's existence, the elder Scholls were no longer with the business; Frank had retired in 1967 and Dr. Scholl died in 1968. It was in 1968 that William H. Scholl, Frank's son, became the chief executive officer of Scholl, Inc., and an officer and director of all the foreign corporations. Shortly thereafter, apparently in 1969, initial consideration was given to Scholl effecting a public issuance of its stock in accordance with the requirements of the Securities and Exchange Commission. As a direct result of the decision to "go public",-the Chicago office, for the first time, began receiving financial information concerning foreign operations, and officers of the domestic corporations were allowed to make meaningful visits to the European operations. During 1969 and 1970 many of the foreign subsidiaries were' acquired or controlling interests in them perfected. Ultimately, stock of Scholl, Inc. was offered to the public late in 1971. The same year an Austrian subsidiary was acquired to manufacture the exercise sandal for ultimate distribution throughout the Scholl organization and a meaningful product flow commenced between the eastern hemisphere and the domestic operations. The record also indicates that by the middle of 1971 Mr. Bart, the principal financial and accounting officer of Scholl, Inc., had become responsible for the financial affairs of the western hemisphere subsidiaries, and that Mr. M. R. Brecknock, joint managing director of the British subsidiary, and a director of Scholl, Inc., was responsible for the financial affairs of eastern hemisphere subsidiaries. 8/

Based upon the facts of this case, we cannot conclude that, during the years in issue, the foreign subsidiaries were engaged in a unitary business with the

8/ Contrary to respondent's assertion, the record does not definitely establish that either Mr. Bart or Mr. Brecknock filled these positions prior to 1971.

parent and the parent's domestic subsidiaries within the scope of either the contribution or dependency test or the three unities test.

A. Contribution or Dependency Test

In attempting to apply the contribution or dependency test respondent first argues that the presence of centralized management is evidenced by integrated executive forces. Respondent maintains that, from 1962 until mid-1968, there was a strong common thread of centralized management running through the parent and the major foreign subsidiaries in the persons of Dr. Scholl, C. F. Scholl and Frank J. Scholl, Sr. From mid-1968 through 1970 the common thread continued through the parent and all the foreign subsidiaries in the person of William H. Scholl. (See, e.g., Chase Brass & Copper Co. v. Franchise Tax Board, supra, 10 Cal. App. 3d 496; Appeal of Harbison-Walker Refractories Co., supra; Appeal of Browning Manufacturing Co., supra; Appeal of F. W. Woolworth Co., supra.)

Ostensibly, at least, the existence of an integrated executive force is indicated. Upon closer examination, however, actual operations belie that indication. First, we note that prior to mid-1968 interlocking directorates existed in only two of six western hemisphere subsidiaries and in only six of twelve eastern hemisphere subsidiaries. Next, we have the unchallenged testimony of Mr. T. P. Bart that Frank J. Scholl, Sr., during his tenure, was the executive solely responsible for the operation of all the eastern hemisphere subsidiaries. That the eastern hemisphere subsidiaries operated as an autonomous unit is emphasized by the almost total lack of financial or operational reporting to the Chicago headquarters of the parent. Furthermore, there was no interchange of executives or employees during the appeal years. Another most significant factor indicating autonomy is that, although Scholl, Inc., owned a majority of the eastern hemisphere subsidiaries' stock, its voting rights were exercised pursuant to proxies given to Frank J. Scholl, Sr. Finally, we note that as long as Frank was in charge of the eastern hemisphere operations, no meaningful visits by executives of the domestic group were allowed.

From all that is contained in the record, the individual western hemisphere foreign subsidiaries appear to have controlled their own destiny as did their counterparts in the eastern hemisphere. With the exception of

an innocuous statement that some supervisory control over these corporations was exercised from Chicago, the record is barren of any meaningful evidence indicating any integrated executive forces. Prior to mid-1968 interlocking directors were minimal. There is no evidence of any financial or operational reporting, and no budgetary or other financial or operational control exercised over the western hemisphere foreign corporations. There was no interchange of executives or other employees. Furthermore, the officers and directors of these corporations also were designated by the resident manager pursuant to proxies received from the Chicago office. There is no evidence that Dr. Scholl or any other domestic executive ever visited the western hemisphere corporations for business purposes or that any western hemisphere corporate executives ever visited Chicago for business purposes.

It is true that Dr. Scholl and Frank met several times each year and that general business discussions occurred during the course of these visits. In view of the other factors discussed above, however, we believe this is insufficient to establish executive control of the major policy of an international organization at the highest level.

In 1968 a transitional period began when many organizational and operational 'changes were instigated. It was during this year that William J. Scholl became the nominal chief executive officer of Scholl, Inc., and all the subsidiaries. Shortly thereafter, apparently sometime in 1969, additional reporting requirements aimed at collecting the information needed to comply with Securities and Exchange Commission regulations were instituted. Presumably, as a result, initial vestiges of control over foreign operations emanated from the Chicago office. However, these changes were not fully implemented until 1971, after the years in issue, when Scholl, Inc. went public. Accordingly, based upon this record, we cannot conclude that centralized management as evidenced by integrated executive forces existed during the appeal years.

Next, respondent argues that there was substantial intercompany product flow, which is a prime indicator of the existence of a unitary business. (See, e.g., Appeal of Beecham, Inc., supra; Appeal of Grolier Society, Inc., supra.) Although, generally speaking, both the domestic and foreign corporations deal in foot and leg care products, there simply was no substantial intercompany product flow between the domestic and foreign groups.

The record indicates that in none of the appeal years did sales by the domestic group to the foreign group exceed one-half of one percent of the domestic group's total net sales. So far as is material, the foreign corporations designed, manufactured and packaged their own products for ultimate distributionand sale solely by other foreign corporations. It was not until 1971, after the appeal years, that an Austrian subsidiary was established to manufacture the exercise sandal for ultimate distribution throughout the Scholl organization and a meaningful product flow commenced between the foreign and domestic operations.

It is true that in an appropriate case the absence of intercompany product flow will not prevent a determination of unity. (See Superior Oil Co. v. Franchise Tax Board, supra; Honolulu Oil Corp. v. Franchise Tax Board supra.) In those cases the other unitary characteristics were so extensive and so substantial resulting in materially increased earnings to the corporation, that the absence of intracompany product flow was not fatal to a determination of the existence of a unitary business. In this appeal, however, there simply are no other substantial unitary characteristics, other than ownership, which are sufficient to require a finding that the foreign subsidiaries were engaged in a unitary business with the domestic group during the appeal years.

Respondent also argues that the free availability of trademarks and patents and the exchange of know-how through integrated executive forces was of substantial value due to the global popularity of Dr. Scholl foot products and is a clear indication of unity between parent, its domestic subsidiaries and the foreign subsidiaries. (Appeals of Perk Foods Co. of California, supra; Appeals of Simonds Saw and Steel Co., Cal. St. Bd. of Equal., Dec. 12, 1967; Appeal of Maryland Cup Corp., Cal. St. Bd. of Equal., March 23, 1970; Appeal of F. W. Woolworth Co., supra.) Respondent urges that the free availability of trademarks and patents is a privilege not usually afforded to separate and distinct companies. According to respondent, the name "Dr. Scholl," which identifies a specific product always found in a familiar yellow package, is used by all the foreign subsidiaries which, without the right to so market their products as Scholl products, would not have enjoyed the marketing success they did.

The use of the Scholl name is not without some significance. However, an analysis of the facts of this

appeal within the parameters of contribution or dependence dilutes that significance. There was no combined international advertising of the Scholl name. Initial development of the foreign markets began shortly after domestic operations commenced in 1904 by the establishment of the Canadian and British corporations in 1910. Thus, foreign and domestic market development was independent and parallel. Initial foreign market penetration did not result because of an established domestic'market. Foreign market penetration continued because of local marketing efforts, not because of international efforts. In the absence of any concerted international advertising, the only way it would become known that the Scholl name was used internationally would be by travelling through the various countries where Scholl products are sold. Considering the nature of the products sold, any resulting benefits would be economically insignificant.

Even if we were to conclude that the international use of the Scholl name materially increased sales, which we do not, in the absence of a centralized manufacturing function to take advantage of economies of scale, or centralized service functions to spread costs over a wider base, the increased sale of Scholl products abroad could have'no material effect on the domestic Scholl group other than to increase the potential for dividends which is a function of ownership and not an indicator of unity. Similarly, for the same reasons', any increased sale of Scholl products by the domestic group could not materially aid the foreign operations.

The appeals relied on by appellant are distinguishable. The use of common trade names or trademarks was either accompanied by common advertisement as in Appeal of Maryland Cup Corp., supra, or was not the sole factor upon which a unitary determination rested as in the other three appeals.

With respect to the patents, it is sufficient to note that they were not material to Scholl's operations. It is true that the exercise sandal was developed and patented in the United States and then registered abroad. However, the exercise sandal did not become a significant unitary.link until an Austrian subsidiary was formed in 1971, after the appeal years, to manufacture and distribute the sandal internationally.

In view of the.autonomous operation of the executive forces, we cannot conclude that there was any substantial benefit derived from any exchange of information and know-how which have been found important in

establishing contribution or dependence in prior appeals. (See, e.g., Appeals of Perk Foods Co. of California, supra; Appeal of Maryland Cup Corp., supra.)

Although occurring prior to the years in issue, the method by which the situation existing after World War II was handled is illuminating. As we have indicated, operations in England and on the European continent were in a shambles after the war. A critical-need existed for cash to defray the costs of rebuilding the destroyed operations. Although the foreign corporations petitioned Scholl, Inc., for assistance, the request for aid went unheeded. Ultimately, the foreign corporations were able to rebuild by their own efforts. This is hardly an indication of a unitary business.

In this appeal we have the ownership requirement satisfied, the international use of the Scholl name, and the beginning, in 1968, of an integrated executive force at the highest levels which was not completed until after the appeal years. The most significant feature is the use of the Scholl name. Under the facts of this appeal, however, such significance is substantially reduced. We conclude that the factors relied upon by respondent to satisfy the contribution or dependency test are insubstantial.

B. Three Unities Test

Unity of ownership, of course, is present here since Scholl, Inc., owns all, or over 50 percent, of the stock of all the foreign corporations in question.

As we have indicated, unity of use is concerned with line functions and relates to executive forces and operational systems. In attempting to establish unity of use, respondent relies on the existence of centralized management as evidenced by integrated executive forces, and intercompany product flow. However, as indicated in our discussion of the contribution or dependency test, we cannot conclude that there was an integrated executive force in fact as opposed to form. As we have also indicated, there was no significant product flow during the years in issue.

Unity of operation concerns staff functions. Here, respondent relies on the use of patents and trademarks and the exchange of know-how. These matters have been discussed previously at some length. We have concluded, that while the availability of patents and trademarks is not without some significance, that significance

is substantially reduced by a factual analysis of the nature and extent of their use. Similarly, as discussed above, we are not convinced that there was a substantial exchange of know-how in view of the autonomous operations of the executive forces. When considering whether unity of operation is present, we are more impressed with the absence of the usual indicators. Centralized staff functions are nonexistent. For example, there is no centralized purchasing, advertising, accounting or financing. Furthermore, there was no exchange of employees during the appeal years. Contrary to respondent's assertion that there was a centralized employee benefit program within the Scholl group, the record does not indicate that any foreign employees were covered other than by the plans of their respective employers.

Respondent also suggests that "Scholl Topics", an in-house newsletter which publishes items of interest from the foreign corporations indicates unity of use. Throughout this appeal respondent has relied on various issues of "Scholl Topics" as well as another publication entitled "Around the World With Foot Comfort" printed by Scholl, Inc.'s advertising department in 1954. The latter publication was described by Mr. Edward Styka, Scholl, Inc.'s director of taxes, simply, as a "sales gimmick." While we have examined these publications, in view of their nature we have assigned little weight to much of their contents.

In view of our determination that unity of use is nonexistent and that unity of operation is, at best, insubstantial, we must conclude that the three unities test is not satisfied.

In accordance with the views set out above we hold with respect to the years in issue that the operations of Scholl, Inc., and its domestic subsidiaries did constitute a unitary business, but that the operations of Scholl, Inc., and its domestic subsidiaries were not unitary with its foreign subsidiaries.

We would be remiss, however, if we did not add that it is quite likely as of 1971, after Scholl, Inc., went public, when integration of executive forces at the highest levels was completed, when the Austrian subsidiary began to manufacture and distribute the exercise sandal on an international scale, and when financial reporting and control were finally implemented, a determination that Scholl's entire international operation constituted a unitary business would be appropriate.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Scholl, Inc. (formerly The Scholl Manufacturing Co., Inc.), Dr. Scholl's Foot Comfort Shops, Inc., Arno Adhesive Tapes, Inc., and Podiatry Supply Headquarters, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Appellant	Income Year	Proposed Assessment
Scholl, Inc.	1967	$ 9,834.00
	1968	9,143.00
	1969	8,861.00
	1970	12,119.00
Scholl Manufacturing Co., Inc.	1962	$ 67.13
	1966	131.95
Dr. Scholl's Foot Comfort Shops, Inc.	1962	$ 3,764.37
	1963	3,899.31
	1964	4,412.49
	1965	4,683.27
	1966	5,805.18
Arno Adhesive Tapes, Inc.	1962	$ 715.27
	1963	485.82
	1964	401.88
	1965	349.65
	1966	302.56
Podiatry Supply Headquarters, Inc.	1962	$ 298.95
	1963	246.76
	1964	392.90
	1965	376.55
	1966	473.31

be and the same is hereby affirmed with respect to the determination that the operations of Scholl, Inc. (formerly The Scholl Manufacturing Co., Inc.) and its domestic subsidiaries constituted a unitary business, and reversed with respect to the determination that the operations of Scholl, Inc. (formerly The Scholl Manufacturing Co., Inc.) and its domestic subsidiaries were unitary with its foreign subsidiaries..

Done at Sacramento, California, this 27th day of September, 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member